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CHARLES ELMORE CHAPLEY  
CLERK

**SUPREME COURT OF THE UNITED STATES**

**OCTOBER TERM, 1941**

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**No. 1186**

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**MODERN FACTORS COMPANY,**

*Petitioner,*

*vs.*

**TASTYEAST, INC.**

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**PETITION FOR WRIT OF CERTIORARI TO THE  
UNITED STATES CIRCUIT COURT OF APPEALS  
FOR THE THIRD CIRCUIT AND BRIEF IN SUP-  
PORT THEREOF.**

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**MAX L. ROSENSTEIN,**  
*Counsel for Petitioner.*

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MODERN FACTORS COMPANY,

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**PETITION FOR WRIT OF CERTIORARI TO THE  
UNITED STATES CIRCUIT COURT OF APPEALS  
FOR THE THIRD CIRCUIT.**

---

*To the Honorable Chief Justice and Associate Justices of  
the Supreme Court of the United States:*

**Summary Statement of Matter Involved.**

1. This case challenges the correctness of a decision by the United States Circuit Court of Appeals for the Third Circuit which reversed that portion of a decree of the United States District Court for the District of New Jersey confirming a plan of reorganization proposed on the part of Tastyeast, Inc. The said decree directed the payment of \$5,645.87 as interest in addition to the amount of a mortgage held by Modern Factors Company covering the chat-

tels of Tastyeast, Inc. The United States Circuit Court of Appeals for the Third Circuit ruled that the agreement to pay the aforesaid interest constituted a penalty and, therefore, unenforcible in bankruptcy.

2. On June 25, 1940, Tastyeast, Inc., a Delaware corporation filed a petition for reorganization under Chapter X of the Bankruptcy Act in the United States District Court for the District of New Jersey. The petition was approved, and the duly appointed trustee took possession of the debtor's business. Subsequently, in the reorganization proceedings, the debtor was adjudged insolvent, but was never adjudicated a bankrupt.

3. On March 25, 1940, the debtor gave its note, as evidence of a debt owing by it to Modern Factors Company, in the sum of \$33,600.00; and, to secure the payment thereof, with interest, executed a chattel mortgage which, by its terms, matured on September 25, 1940. (Appendix below, pp. 8-9.) At the time of the filing of the petition for reorganization, the principal indebtedness had been reduced by payments to the sum of \$31,600.00. At maturity the balance of the principal became due and was not paid. The debtor was in default. From and after September 25, 1940, interest on said unpaid balance was to be paid at the rate of  $2\frac{1}{2}\%$  per month. (Appendix below, p. 9.)

4. The debtor proposed a plan of reorganization, subsequently altered, which made provision for the payment of the mortgage debt, and, among other things, provided for the formation of a new company, “\* \* \* to which shall be transferred all of the property and assets of the debtor, and which shall stand in the same position with respect to the altered plan as debtor”. (10 (a) Order Confirming Altered Plan, etc., Appendix, p. 3.)

5. Under the plan, as altered, it was also proposed that the mortgagee was to be paid interest on the principal

balance of its debt after September 25, 1940, *not at the rate fixed by the contract, but at a rate to be fixed by the court upon hearing for confirmation of the plan.*

6. Modern Factors Company was the only creditor of its class. The foregoing proposal in the altered plan was intended to specifically apply to, and affect the claim of, Modern Factors Company as a secured creditor, and the only one of its class. Objection was made on the part of this creditor to the approval of the plan, contending that the debt due to it was fixed by the contract which could not be impaired by the court without its consent; and, that the court could not legally adjudicate the proposed altered plan to be fair, equitable, and feasible unless provision was made therein for the payment of the mortgagee's claim in full, with interest, as provided for in the chattel mortgage.

7. On due notice, application was made by the debtor, to the Referee in Bankruptcy before whom the reorganization proceedings were pending, to have the interest which had accrued since maturity of the mortgage, fixed.

8. The Referee reported to the District Court (a) that there was no question about the validity of the mortgage in the case at bar; (b) that the Court was considering a reorganization proceeding, and there appeared to be a serious doubt that security could be taken away from a secured creditor without paying him in full, unless the claim was an illegal one; and, (c) that the contract here was free from fraud and duress. The Referee upheld the contentions of Modern Factors Company. (See Referee's Report on Confirmation of Altered Plan, which was part of the record on appeal in the court below, and appears in Appendix "C" hereto annexed, and referred to on page 3, Appendix below.) The Referee's findings were approved by the District Judge (Appendix below p. 7). An order was made

by the District Court confirming the altered plan, with leave to the debtor to appeal from that portion of the order which directed the payment of interest to Modern Factors Company at the rate provided for in the mortgage. The amount of said interest was calculated at \$5,645.87, and was deposited with the Clerk of the United States District Court, pending the determination of an appeal, if any were taken. The appeal was taken by the new corporation which succeeded the debtor, and, the United States Circuit Court of Appeals for the Third Circuit reversed the District Court upon the sole ground that the provision in the mortgage which called for the payment of interest at the rate of  $2\frac{1}{2}\%$  per month from and after the default which occurred on September 25, 1940, the date of maturity of the mortgage, though not usurious, constituted an agreement for a penalty and was unenforceable in bankruptcy.

9. The Circuit Court of Appeals below refrained entirely from passing upon the contentions urged and sustained on the part of Modern Factors Company in the District Court; namely, (a) that the court could not lawfully take away from the only secured creditor of its class a portion of its claim and give it to the debtor; (b) that a plan of reorganization which contemplated such a result could not be held to be fair, equitable and feasible; and, (c) that a secured creditor was entitled to payment of the full amount of the mortgage debt and agreed interest to the date of payment. The court confined its discussion to, and based its opinion solely upon, the question of penalty. The determination by the Circuit Court below, was based solely upon speculation, and upon an assumption of facts nowhere appearing in the record. (See Conclusions on pages 2 and 6, Opinion C. C. A., Filed March 19, 1942.) (R. 17, 21.) Petitioner contends that the determination by the Circuit Court of Ap-

peals below was erroneous and violative of its constitutional rights, upon the grounds more particularly herein-after set forth.

10. This is a petition for a Writ of Certiorari to review the decision of the United States Circuit Court of Appeals for the Third Circuit, and, the questions presented for determination upon this petition are set forth in Appendix "B" hereto annexed.

### **Reasons Relied Upon for the Allowance of the Writ.**

1. This case presents questions of constitutional issues which, petitioner contends, were determined in its favor in the District Court after full consideration of all questions of fact and law.

2. The determination of the United States Court of Appeals for the Third Circuit reversing the District Court deprives petitioner of its property and rights to property without due process of law, and is in complete disregard of the rights of petitioner, which did not consent to the reduction of its claim or the modification of its rights. Petitioner contended that the plan of reorganization could not be adjudicated fair, equitable, and feasible unless petitioner's claim was paid in full, together with agreed interest to the date of payment.

3. It is respectfully submitted that the determination by the Circuit Court of Appeals below is clearly erroneous and not in accord with the principles of applicable decisions of this court in the following cases, among others:

*Louisville Joint Stock Land Bank v. Radford*, 295 U. S. 555, 55 S. Ct. 854, 79 L. Ed. 1593;

*Continental Illinois National Bank & Trust Co. v. Chicago Rock Island and P. Ry. Co.*, 294 U. S. 648, 79 L. Ed. 1110;

*Cumberland Manufacturing Co. v. Dewitt*, 237 U. S. 447, 35 S. Ct. 636, 59 L. Ed. 1043;  
*333 North Michigan Ave. Bldg. Corp.*, 84 F. (2d) 936;  
*Case v. Los Angeles Lumber Products Co.*, 308 U. S. 106, 84 L. Ed. 110;  
*In re Herweg*, 119 F. (2d) 941;  
*In re Chapman v. Security &c. Bank*, 111 F. (2d) 86.

4. Insofar as the decision denied to petitioner the right to payment of the full amount of its mortgage debt, with interest to the date of payment at the rate fixed by written agreement between the parties, the same is not in accord with the decisions of this court. *In re American Iron & Steel Co. v. Seaboard Airline Ry.*, 233 U. S. 261, 43 S. Ct. 502, 59 L. Ed. 949; *Louisville Joint Stock Land Bank v. Radford*, *supra*; *Continental Illinois National Bank & Trust Co. v. Chicago*, *supra*; *Case v. Los Angeles Lumber Products Co.*, *supra*; and, the said decision conflicts and is irreconcilable with the decisions of the Circuit Courts of Appeal in the Second, Fourth, Fifth, Sixth, Eighth, and Tenth Circuits, in the following cases:

*In re Deep Rock Oil Corp.*, 113 F. (2d) 266 (C. C. A. 10th Cir.);  
*Spring Coal Co. v. Keech* (C. C. A. 4th Cir.) 249 Fed. 38;  
*Central Trust Co. v. Condon* (C. C. A. 6th Cir.), 67 Fed. 84;  
*McFarlan v. Hurley* (C. C. A. 5th Cir.), 286 Fed. 355;  
*Board of Commissioners v. Bernardin* (C. C. A. 10th Cir.), 74 Fed. 809;  
*First National Bank v. Ewing* (C. C. A. 2nd Cir.);  
*Gotham Can Company Case*, 48 F. (2d) p. 542 (C. C. A. 2nd Cir.);  
*In re Matter of International Raw Material Corp.*, 22 F. (2d) (C. C. A. 2nd Cir.);  
*In re Coder v. Arts* (C. C. A. 8th Cir.) 152 Fed. 943.

5. The United States Circuit Court of Appeals for the Third Circuit clearly erred, we submit, by unlawfully extending the scope and operation of Chapter X of the Bankruptcy Act; and, by its decision conferred a license upon the debtor seeking reorganization to retain to its own use property pledged by it as security for its debt, and to impair that debt. This determination is contrary to the accepted principles applicable to the facts in the case at bar, and is utterly in conflict with the decisions of this court and other Circuit Courts of Appeal. The Circuit Court of Appeals below disregarded the distinction between the administration of the estate of a bankrupt as distinguished from the manner in which assets of a corporate debtor are dealt with in reorganization proceedings. The cases disregarded and overruled are:

*In re Garden City Canning Co.*, 29 Fed. Supp. 13;  
*In re Security First National Bank v. Rindge Land and Navigation Co.*, 85 F. (2d) 557 (C. C. A. 9th Cir.);  
*Case v. Los Angeles Lumber Products Co.*, *supra*.

6. To the extent that the decision below sustained the claim that the agreement for the payment of the interest provided for in the mortgage after maturity was a penalty and, therefore, unenforceable, it is not in accord with the applicable decisions of the State of New Jersey on the question of whether a contract such as existed in the case at bar, constituted an agreement for an unenforceable penalty. The New Jersey Supreme Court in *re Ramsey v. Morrison*, 39 N. J. L. 591, 593, held that a contract to increase interest after default is not an agreement to exact a penalty. The same rule was laid down by this court in *re Lloyd v. Scott*, 4 Pet. 205, 7 L. Ed. 833; and, is the rule which prevails in the States of Arkansas, Idaho, Iowa, Illinois, Maine, Massachusetts, Minnesota, Nebraska, New Jersey, Oregon, Virginia, Wisconsin, and in England.

7. The United States Circuit Court of Appeals for the Third Circuit went beyond and de hors the record for the basis of its determination. The decision of the court below rests upon assumptions of fact nowhere appearing in the record, and was predicated upon speculation. (See pages 2 and 6 of Opinion, C. C. A., March 19, 1942.) (R. 17, 21.)

8. The case relied upon by the Circuit Court of Appeals below, to wit, *Kothe v. Taylor*, 280 U. S. 224-226, is clearly distinguishable and inapplicable, for, the theory underlying the decision in that case was that the parties to the contract therein were consciously undertaking to contract for payment to be made out of the assets of a bankrupt estate at the expense of the creditors, and not for something which the lessee there personally would be required to discharge.

9. In the case at bar, the creditors are not affected by the contract, but the debtor alone, and, it is the debtor who seeks to obtain the benefit of its own contract, resorting to reorganization under Chapter X to accomplish what it could not otherwise achieve.

10. The Circuit Court below in rendering its decision has decided an important question of general law in a way untenable and in conflict with the great weight of authority which holds that a provision in a note or other contract for the payment of money by which the debtor agrees to pay, after maturity and default, interest at a higher rate than permitted by the usury laws, or, a sum of money which will exceed that rate, does not render a note or other contract usurious if the parties in making the contract act in good faith, without intent to evade the usury law. In the case at bar, the good faith of the chattel mortgagee has never been questioned, and the mortgage

was found to be free from fraud and duress. (See Referee's Opinion, Appendix "C" hereto annexed).

11. The decision by the court below stripped the mortgagee of its contract rights, and unlawfully conferred the benefits thereof upon the debtor. This constituted a taking away of a substantive property right of the mortgagee, contrary to the Fifth and Fourteenth Amendments of the Constitution of the United States, and was contrary to the rights of the mortgagee under the case of *Fox v. Cronan*, 47 N. J. L. 493, cited with approval in *Smith v. Koenig*, 57 N. J. L. 486, and *Finkel v. Lepkin*, 62 N. J. L. 580.

12. In the interest of brevity (Rule 38, paragraph 2) petitioner restricts further discussion on these points, but in order to comply with the rules of this court which require that all issues upon which decision is requested be presented in the petition for certiorari, petitioner here refers to and incorporates into this petition, all of the matters presented to the United States Circuit Court of Appeals for the Third Circuit in the transcript of the record on appeal, with the same force and effect as if herein set out in full.

WHEREFORE, petitioner prays that a Writ of Certiorari be issued out of and under the seal of this Honorable Court, directed to the United States Circuit Court of Appeals for the Third Circuit, commanding that court to certify and send to this court for its review and determination, on a day certain to be therein named, a transcript of the record and proceedings herein; and, that the decree of the United States Circuit Court of Appeals for the Third Circuit be reversed by this Honorable court, and, your petitioner have such other and further relief in the premises as to this Honorable court may seem meet and just.

MAX L. ROSENSTEIN,  
Counsel.

**APPENDIX "A".****Constitutional Provisions, Federal Statute and General Law Involved.**

1. That portion of the Fifth Amendment to the Constitution of the United States which provides:

"No person shall \* \* \* be deprived of life, liberty, or property without due process of law."

2. That portion of the Fourteenth Amendment, Section (1) which, among other things, provides:

"\* \* \* nor shall any State deprive any person of life, liberty, or property without due process of law, nor deny to any person within its jurisdiction the equal protection of the laws."

3. That portion of Article X, Sec. 216, sub-division (7), of "An Act to establish a uniform system of bankruptcy throughout the United States", approved July 1, 1898, and Acts amendatory thereof and supplementary thereto, and as amended to July 1938, U. S. C. A. sections 501-676, which provides that a plan of reorganization under the chapter:

"(7) shall provide for any class of creditors which is affected by and does not accept the plan by the two-thirds majority in amount required under this chapter, adequate protection for the realization by them of the value of their claims against the property dealt with by the plan and affected by such claims, either as provided in the plan or in the order confirming the plan, (a) by the transfer or sale, or by the retention by the debtor, of such property subject to such claims; or (b) by a sale of such property free of such claims, at not less than a fair upset price, and the transfer of such claims to the proceeds of such sale; or (c) by appraisal and payment in cash of the value of such claims; or (d) by such method as will, under and consistent with the circumstances of the particular case, equitably and fairly provide such protection."

and Article XI, Sec. 221, sub-division (2) which provides: "The judge shall confirm a plan if satisfied that (2) the plan is fair and equitable, and feasible."

4. The general law involved relates to the rule generally accepted and which prevails in the State of New Jersey, that a provision in a note or other contract for the payment of money by which a debtor agrees to pay, after maturity, interest at a higher rate than permitted by the usury law, or, a sum of money which will exceed that rate, does not render the note or other contract usurious, and is enforceable.

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## **APPENDIX "B".**

### **Questions Presented.**

1. Did the court below, in holding the provision in the mortgage for interest at  $2\frac{1}{2}\%$  per month after maturity and default to be a penalty, take away a substantive property right from the mortgagee in violation of the Fifth and Fourteenth Amendments to the Constitution of the United States?

2. Did the court below err in reversing the ruling of the District Court, that under Chapter X of the Bankruptcy Act, when a class of creditors consists of only one party, its consent must be obtained before its claim can be affected by the plan of reorganization?

3. Did the court below err in apportioning the claim of the mortgagee, (the mortgage having been held valid by the District Court), by taking from the mortgagee the interest payable to it under the terms of the chattel mortgage, and turning it back to the debtor or its successor?

4. Was it lawful for the court below to require petitioner, a secured creditor, to share its inadequate security with an insolvent debtor?

5. May a plan of reorganization which required a secured creditor, the only one of its class, to accept less than the

full amount of a mortgage debt and accrued and agreed interest to the date of payment, be deemed to be fair, equitable and feasible, under Chapter X of the Bankruptcy Act?

6. Did the court below err in failing to follow applicable general law and local decisions of the courts of New Jersey that a contract to increase interest after default does not constitute a penalty?

7. Did the Circuit Court of Appeals below decide the foregoing questions in a manner in conflict with applicable decisions of this court, as well as of the courts of New Jersey, so as to call for an exercise of this court's power of supervision?

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### **APPENDIX "C".**

#### **Referee's Recommendation on Rate of Interest to be Paid to Modern Factors Company.**

"At the hearing before me on May 26, 1941, the Debtor filed a notice served on Modern Factors Company that it would apply to have the interest on the chattel mortgage held by Modern Factors Company fixed by the Court. Max L. Rosenstein, Esquire, appeared for the Modern Factors Company.

This question was argued before me on the 26th day of May, 1941. The plan provides: 'The Debtor shall pay Modern Factors Company the principal amount due of \$31,600.00 plus interest thereon from September 25, 1941, at a rate to be fixed by the Court upon the hearing for confirmation of the plan as altered.'

It is conceded by the parties that there is \$31,600.00 due on the principal of this mortgage, together with interest from September 25, 1940, on which date the mortgage became due. On March 25, 1940, the date of execution of the mortgage, the interest for six months was paid in advance. The mortgage provided that if it was not paid on the due date, September 25, 1940, interest would accrue on the mortgage at the rate of  $2\frac{1}{2}\%$  per month.

It is the contention of the debtor that in view of the fact that the petition herein was filed prior to September 25, 1940, that therefore the claimant can only insist upon the receipt of interest at the rate of 6% per year from the 25th day of September, 1940. The Modern Factors Company contends that the interest rate fixed in the mortgage was agreed to between the parties and that therefore by law they are entitled to payment in full according to the provisions of the said mortgage. It is further contended by the debtor, that according to the Statutes of the State of New Jersey, being Compiled Statutes of New Jersey, 1937, 31:1-1, the law of New Jersey prohibits interest in excess of 6%. It is further contended that although Revised Statutes of New Jersey, 31:1-6, prohibits corporations from pleading usury, nevertheless the Modern Factors Company are prohibited from collecting in excess of 6% since September 25, 1940, because of the proceedings herein. The Debtor cites the case of *Dayton versus Stanard*, 60 L. Ed. 1190; 241 U. S. 598. This case holds that where there was a tax sale held without the authority of the Bankruptcy Court, which sale was later declared void, the purchaser at said tax sale could recover back the amount paid for the tax certificate but could not recover the amount of larger interest which was required on redemption of tax sales. It would appear, however, that this cause is not exactly in point as the claimant in that case might have been considered as a volunteer in making the said payments. The debtor also mentions the case of *Martin Custom Made Tire Corporation*, 108 Fed. (2d) 172, (Second Circuit, 1939), where it is held that a mortgage which was void as to a Trustee in bankruptcy is also void as to the debtor in reorganization (even though it would be good between the parties, to wit: an unrecorded mortgage). In other words, it is insisted that the debtor is in the position of a Trustee in Bankruptcy, and that as against the Trustee no more than 6% could be recovered subsequent to September 25, 1940.

However, there is no question about the validity of the mortgage in the case at bar. We are here considering a reorganization proceeding, and there appears to be a serious doubt that the security can be taken away from a creditor

without paying him in full, unless the claim is an illegal one. The United States Circuit Court of Appeals, for the Second Circuit, has held in a similar case, *In the Matter of International Raw Material Corporation*, 22 Fed. (2d) 920, as follows: 'Where there seems to be no doubt that the parties agreed among themselves to pay 6% as interest on a loan and an additional sum of  $1\frac{1}{2}\%$  per month as so-called Commissions, we know of nothing to prevent such an agreement. The New York Statute provides that no corporation shall interpose the defense of usury, and this has been held to repeal usury laws so far as contracts of corporations are concerned. Neither the corporation nor those who succeed to its rights, nor its sureties, are heard to object to their bargain, either at law or in equity because of usury.' Later on the same opinion holds as follows: 'Corporation contracts to pay more than the statutory rate of interest have been and we believe should be left to the agreement of the parties and not disturbed in the absence of fraud and duress.' See also *Gotham Can Co.*, 48 Fed. (2d) 540.

It would appear from the latter two authorities that a creditor with security could collect interest in accordance with the contract made between the parties, and that this should not be disturbed in the absence of fraud and duress. There appears to be no evidence of fraud and duress in this matter, and I therefore recommend that an order be entered that the debtor pay the Modern Factors Company its claim for \$31,600.00, together with interest at the rate of  $2\frac{1}{2}\%$  per month from September 25, 1940."



**SUPREME COURT OF THE UNITED STATES**

**OCTOBER TERM, 1941**

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**No. 1186**

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**MODERN FACTORS COMPANY,**

*Petitioner,*

*vs.*

**TASTYEAST, INC.**

---

**BRIEF IN SUPPORT OF PETITION FOR CERTIORARI.**

---

**I.**

**Opinion Below.**

The opinion of the United States Circuit Court of Appeals for the Third Circuit was rendered March 19, 1942, and is reported in — F. (2d) — .

**II.**

**Jurisdiction.**

The jurisdiction of this Court is invoked under Section 0-A of United States Judicial Code as amended by Act February 13, 1925, 28 U. S. C. A. Sec. 347-A.

## III.

**Statement of Case.**

The essential facts in the instant case are fully set forth in the accompanying petition for Writ of Certiorari, and for the sake of brevity are omitted here. All necessary elaboration of the points involved will be made in the Argument which follows.

## IV.

**Constitutional Provisions, Federal Statutes and General Law Involved.**

A statement of the pertinent portions of the Constitution of the United States, the Bankruptcy Act, and the principles of general law involved, will be found in Appendix "A" hereto annexed and made a part hereof.

## V.

**Specification of Errors.**

The questions presented for determination are set forth in Appendix "B" hereto annexed and made a part hereof.

We submit that the legally correct answers to these questions call for a determination by this Court that the decision of the Circuit Court of Appeals below was erroneous. It will be urged that it was error for the Circuit Court of Appeals below to determine these questions adversely to the petitioner.

## VI.

**ARGUMENT.**

## POINT 1.

The decision of the Circuit Court of Appeals in the instant case is in direct conflict with, and contrary to, the decisions of this Court and other Circuit Courts of Appeal, and deprives petitioner of its property and rights to property without due process of law.

Petitioner throughout the proceedings in the court of original jurisdiction, and in the Circuit Court of Appeals, insisted that inasmuch as it was the only secured creditor of its class, there was no authority for the confirmation of any plan of reorganization which authorized the debtor to pay this secured creditor less than the full amount of the debt, with interest, as agreed, while retaining to its own use a portion of the property securing the debt. To do so does violence to the substantive property rights of petitioner, and is inconsistent with the Fifth and Fourteenth Amendments to the Constitution of the United States. This Court laid down the principles applicable to the facts in the instant case in *Re Louisville Joint Stock Land Bank v. Radford*, 295 U. S. 555, 79 L. Ed. 1593; *Continental Illinois National Bank & Trust Co. v. Chicago, Rock Island and P. Ry. Co.*, 294 U. S. 648; and, *Case v. Los Angeles Lumber Products Co.*, 308 U. S. 106, 60 S. Ct. 1.

The Circuit Court of Appeals for the 9th Circuit, in *Re Security-First National Bank v. Rindge Land & Navigation Co.*, 85 F. (2d) 557, at p. 561 (C. C. A. 9th), in reversing an order and decree confirming a plan of reorganization, said:

“There is nothing in section 77B which authorizes a debtor to pay a secured creditor less than half the amount of the debt while retaining to its own use a por-

tion of the property securing the debt. The right to retain a lien until the debt secured thereby is paid is a substantive property right which may not be taken from the creditor consistently with the Fifth and Fourteenth Amendments to the Constitution. *Louisville Joint Stock Land Bank v. Radford*, 295 U. S. 555, 594, 28 Am. B. R. (N. S.) 397, 55 S. Ct. 854, 79 L. Ed. 1593, 97 A. L. R. 1106."

In *Re 333 No. Michigan Ave. Bldg. Corp.*, 84 F. (2d) 936, the Circuit Court of Appeals for the 7th Circuit dealt with a situation similar to the instant case. The debtor there had a class of creditors consisting of only one party, and the court held at p. 940:

"Under Section 77B, the rights of all claimants and creditors are entitled to the same protection, but they may be divided into classes, as was done in this proceeding. That law requires a two-thirds vote of each class before a plan can be confirmed, and that provision was complied with in the case before us. *When a class consists of only one party, regardless of the nature of his claim, his consent must be obtained, provided his claim is affected by the plan.* (Citing) *Continental Illinois Nat. Bank & Trust Co. v. Chicago, Rock Island & Pacific Ry. Co.*, 294 U. S. 1110; *Louisville Joint Stock Land Bank v. Radford*, 295 U. S. 555, 28 Am. B. R. (N. S.) 397, 55 S. Ct. 854, 79 L. Ed. 1593, 97 A. L. R. 1106; *Cumberland Glass Manufacturing Co. v. DeWitt*, 237 U. S. 447, 34 Am. B. R. 723, 35 S. Ct. 636, 59 L. Ed. 1043."

It is to be noted that the Circuit Courts of Appeal in the two cases from which the foregoing excerpts appear, regarded the *Louisville Joint Stock Land Bank v. Radford* case, *supra*, as controlling, and the final judicial word on the subject.

The United States Circuit Court of Appeals for the Third Circuit, nevertheless, disregarded these binding principles

of law, resulting in an invasion of petitioner's rights thereunder. These principles are supported by *Case v. Los Angeles Lumber Products Co.*, *supra*.

In *re Herweg*, 119 F. (2d) 941, (C. C. A. 7th), the court, in following *Louisville Joint Stock Land Bank v. Radford*, *supra*, and *Case v. Los Angeles Lumber Products Co.*, *supra*, passed upon a real property arrangement under Chapter XII. It applied the principles established in *Louisville Joint Stock Land Bank v. Radford*, stating that many of the observations of Mr. Justice Brandeis were peculiarly applicable, and said:

"We therefore hold that section 461 (11) does not authorize the court to force secured creditors unanimously opposed to the plan, to accept payment of a reduced amount of their claims and leave the debtor in possession of the property formerly securing those claims entirely free from their burden \* \* \*"

" 'This right of the mortgagee to insist upon full payment before giving up his security has been deemed of the essence of a mortgage' \* \* \*"

" 'In no case of composition is a secured claim affected except when the holder is a member of a class; and then only when the composition is desired by the requisite majority and is approved by the court'."

In the case of *Chapman v. Security &c. Bank* (C. C. A. 7th), 111 F. (2d) 86, at p. 87, the court, in referring to *Los Angeles Lumber Co.*, case, *supra*, said:

"The case last cited is directly applicable to the facts of this case, for it was there held that any plan which required a secured creditor to share his inadequate security with an insolvent debtor was unfair and inequitable within the meaning of the Bankruptcy Act, Sec. 77B, sub. (f) 11 U. S. C. A. Sec. 207, sub. (f)."

It is respectfully submitted that the authorities cited in support of this point manifestly demonstrate the error into

which the Circuit Court of Appeals below fell, in its determination.

## POINT 2.

**The Circuit Court of Appeals in denying petitioner agreed interest on its secured claim to the date of payment, ruled contrary to the established principles of law laid down by this Court that a creditor holding a secured claim is entitled to interest to the date of payment.**

The attention of the court below was called to the opinion in the case of *In re Deep Rock Oil Corp.*, 113 F. (2d) 266, at p. 269, (C. C. A. 10th Cir.), which involved an appeal from an order denying a claimant the right to participate in a reorganization plan, it being contended in the course of the controversy that the court below had erred in allowing interest to the note holders and preferred stock holders of the debtor corporation. The inference is clear that the interest there allowed was at the rate provided for in the notes and in the preferred stock. The court held:

*"A creditor holding a prior lien is entitled to interest to the date of the payment out of the proceeds derived from the property covered by such lien. Spring Coal Co. v. Keech (C. C. A. 4th Cir.), 239 Fed. 48 L. R. A. (1917D) 1152; Central Trust Co. v. Condon (C. C. A. 6th Cir.), 67 Fed. 84; McFarland v. Hurley (C. C. A. 5th Cir.), 286 Fed. 365; Board of Com'rs of Sweet Water County, Wyo. v. Bernardin (C. C. A. 10th Cir.), 74 F. (2d) 809. \* \* \*"*

The case of *American Iron & Steel Co. v. Seaboard Air Line Ry.*, 233 U. S. 261, was also cited by the court in *Re Deep Rock Oil Corp.*, *supra*. It involved the right of recovery of interest on a claim against a railway company during the period of a receivership. This Court answered the question in the affirmative in a most illuminating opinion by Mr. Justice Lamar, who, in discussing the treatment to be accorded to the various classes of creditors, considered them

on the basis of whether they were of equal dignity. After restating the well-known rule that on ordinary debts interest terminates at the date of adjudication in bankruptcy, Lamar, J., said (at p. 267):

“The principle is not limited to cases of technical bankruptcy, where the assets ultimately prove sufficient to pay all debts in full, but principal as well as interest accruing during a receivership, is paid on debts of the highest dignity, even though what remains is not sufficient to pay claims of a lower rank in full. *Central Trust Co. v. Condon*, 14 C. C. A. 314, 31 U. S. App. 387, 67 Fed. 84; *Richmond & I. Constr. Co. v. Richmond, N. I. & B. R. Co.*, 34 L. R. A. 625, 15 C. C. A. 289, 31 U. S. App. 704, 68 Fed. 116; *First Nat. Bank v. Ewing*, 43 C. C. A. 150, 103 Fed. 190.”

continuing further:

“\* \* \* *For, manifestly, the law does not contemplate that either the debtor or the trustees can, by securing the appointment of a receiver, stop the running of interest on claims of the highest dignity.*”

The District Court in the case at bar stated (Appendix below, p. 7), in confirming the Referee who found for petitioner, that the case of *International Raw Material Corp.*, 22 F. (2d) 923 (C. C. A. 2nd Cir.), was judicial guidance to his court. That case involved an appeal from an order directing a factor to pay over to a trustee certain moneys retained by it to cover attorneys' fees, commissions, and interest charges, secured by a lien asserted by the factor against accounts receivable assigned to it by the bankrupt. The court stated the question in the following manner:

“(1) Can an agreement by a corporation to pay a rate of interest or a commission in excess of the legal rate be held invalid by a court of bankruptcy, having the custody of a fund which is collateral security for the performance of the agreement, upon the ground that a

lien upon that fund for an excessive rate is unconscionable and should not be sanctioned by a court of equity?"

By way of answer, it said:

"\* \* \* In *Boise v. Talcott* (C. C. A. 2nd Cir.), 45 Am. B. R. 117, 264 F. 61, this court allowed interest charges of 6 per cent, plus commissions of 10 per cent for acting as selling agents, together with a discount of 10 per cent on each loan to the bankrupt. *There seems no justification in nullifying the agreement of the parties here, because the interest and commissions which they deliberately arranged were too large to satisfy the idea of a court. Here, as in other similar cases, the competition of the market fixes rates. The statute has not attempted to control usury contracts made by corporations. Any decision by a court as to what would be a reasonable rate would either have to vary with the kind of security furnished or else be a mere doctrinaire pronouncement. Corporate contracts to pay more than the statutory rate of interest have been, and we believe should be, left to the agreement of the parties, and not disturbed, in the absence of fraud or duress.*"

Circuit Court Judge Augustus N. Hand, who wrote the opinion in *Re International Raw Material Corp.*, *supra*, also wrote the opinion in *Re Gotham Can Company*, 48 F. (2d) 540, in which case the question of the right of a secured creditor to accrued interest up to the date of payment, was under consideration. There an agreement had been made between a bankrupt and a finance company whereby the latter advanced money to the bankrupt upon the security of accounts receivable, and the bankrupt was to pay 1/30 of 1 per cent of the face value of such accounts for each day from the date of purchase. The District Court disallowed charges accruing after adjudication. Upon appeal, this order was modified by the Circuit Court of Appeals holding

that the rights of the parties are governed by the contract. The court interpreted *Sexton v. Dreyfus*, 219 U. S. 339, 31 S. Ct. 256, 55 L. Ed. 244 and said at p. 542:

“The Supreme Court, following the English decisions, accordingly held that a creditor in such circumstances must first apply his security to the liquidation of the debt, with interest to the date of the petition. *It was never suggested that he could not pay interest accruing up to the very date of payment out of the proceeds of the collateral if he might thus satisfy his entire claim. That he may do this has frequently been held, and any other result would be contrary to section 67d of the Bankruptcy Act.*” (Citing numerous cases.)

### POINT 3.

**Under the applicable decisions of the Courts of New Jersey, the agreement for the rate of the interest provided for in the mortgage was not an agreement for a penalty. In failing to follow these decisions the Circuit Court of Appeals below erred.**

The mortgage debt was found valid and free from fraud and duress. (See Referee's Opinion, Appendix “C” hereto.)

In the case of *Ramsey v. Morrison*, 39 N. J. L. 591, which reflects the general law in New Jersey, the Supreme Court of New Jersey succinctly stated the facts before it and the law applicable thereto, as follows:

“The contract between these parties, as shown by the note and the agreement, was, that the defendant, in consideration of the loan of \$250, made to him at the time, would, in one month from the date of the loan, pay the same back to the plaintiff, with lawful interest; and that if he failed to make such payment, according to the terms of the contract, that the twenty-five shares of stock placed in the hands of the defendant, by way of collateral security, should be forfeited to the plaintiff.

This provision of forfeiture was by way of penalty for the non-performance of the contract. The contract itself called for no more than the payment of the sum loaned, with legal interest upon it, and the borrower had the right to pay to the plaintiff the principal and interest, according to the terms of his contract, and thereby avoid the penalty. It is essential to the nature of usury that a certain gain, exceeding the legal rate of interest, is to accrue to the lender as a consideration for the loan. *If the gain to the lender, beyond the legal rate of interest, is, by the contract, made dependent on the will of the borrower, as where he may discharge himself from it by the punctual payment of the principal, the contract is not usurious.* *Pomeroy v. Ainsworth*, 22 Barb. 120; 2 Parsons on Notes and Bills 413, cases cited in note y; *Cutler v. How*, 8 Mass. 257; Parsons on Con. (5th ed.) 116, and notes; *Roberts v. Trenayne*, Cro. Jac. 509."

"This case comes clearly within the principle stated. The contract is not usurious. This being the only point raised, the plaintiff is entitled to judgment upon the report, and the rule is discharged."

The Circuit Court of Appeals, on page 5 of its opinion (R. 21), mootnote 24, conceded that the *Ramsey* case is the only one in New Jersey on the proposition that an agreement such as is involved herein is not usurious in New Jersey, because the debtor could discharge itself from the obligations thereunder by punctual payment of the principal, finding that the agreement did not exceed the highest applicable rate prescribed by law.

The opinion of the Supreme Court of New Jersey is in accord with the principles of law established by this Court in *re Lloyd v. Scott*, 4 Pet. 205, 7 L. Ed. 833, and, the same rule prevails in the States of Arkansas, Idaho, Iowa, Illinois, Maine, Massachusetts, Minnesota, Nebraska, New Jersey, Oregon, Virginia, Wisconsin, and in England.

The Circuit Court of Appeals below was in duty bound

to follow and accept as the law applicable here, the principles laid down in *Ramsey v. Morrison*, and *Lloyd v. Scott*, *supra*. In failing to do so, the court erred. *Fidelity Union Trust Co. v. Field*, 311 U. S. 169, 85 L. Ed. 109.

*In re Downey v. Beach*, 78 Ill. 53, cited in American and English Annotated Cases, Vol. 7 p. 490, the court, in passing upon a comparable situation where no fraud was practiced by a lender to procure a note with a provision for payment of 30% after maturity, said:

“If he has suffered injury that may now seem grievous, it is attributable alone to his (the maker’s) own laches. It is his own contract which is valid at law, and a court of equity will not interfere to set it aside.”

We submit that the contract, being enforceable, and one not calling for a penalty under applicable New Jersey decisions, the court could not equitably set the same aside in whole or in part.

The case relied upon by the Circuit Court of Appeals below, to wit, *Kothe v. Taylor*, 280 U. S. 224, 226 is not applicable, and an examination of that case clearly demonstrates the force of our argument. In that case the theory underlying the decision was that the parties to the contract were consciously undertaking to contract for payment to be made out of the assets of a bankrupt estate at the expense of the creditors, and not for something which the bankrupt lessee there personally would be required to discharge. There was no reasonable relationship between the obligation undertaken and the effect upon a breach thereof. In the case at bar, the creditors are not affected by the contract, but only the debtor, and it is the debtor who seeks to obtain the benefit of its own contract, resorting to reorganization under Chapter

X to accomplish what it could not otherwise achieve. The rate of interest agreed to be paid after default was reasonably comparable to the rate actually paid prior thereto. It is therefore, respectfully contended that the cases are neither analogous nor comparable, and the principles of law laid down in *Kothe v. Taylor, supra*, are wholly inapplicable.

#### POINT 4

**The Circuit Court below in rendering its decision has decided an important question of general law in a way untenable and in conflict with the great weight of authority.**

The principles of general law applicable to the facts in the case at bar are stated in 82 A. L. R. 1214, and have heretofore been otherwise referred to and argued under the preceding point with convincing and appropriate citation of authorities.

The obvious object and avowed intent of the debtor, and the new corporation which succeeded it under the plan of reorganization, was to obtain the benefits of accrued interest belonging to petitioner under the terms of the contract. This resulted in stripping the mortgagee of his contract rights, and constituted confiscation without legal warrant. It was an attempt to rewrite the contract without legal justification. See *Fox v. Cronan*, 47 N. J. L. 493, cited with approval by the Supreme Court of New Jersey, in *Smith v. Koenig*, 57 N. J. L. 486, and *Finkel v. Lepkin*, 62 N. J. L. 580.

The Circuit Court of Appeals below failed to apply these accepted principles of law as they were applicable here, and so far departed therefrom as to call for an exercise of this Court's power of supervision. *Fidelity Union Trust Co. v. Field, supra*.

**Conclusion.**

It is respectfully submitted, therefore, that in order that the errors herein pointed out may be corrected and justice done; and the law properly and authoritatively defined; that the judgment of the United States Circuit Court of Appeals for the Third Circuit should be reviewed and reversed, and, to such an end a Writ of Certiorari should be granted.

MAX L. ROSENSTEIN,  
*Counsel for Petitioner.*

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# Supreme Court of the United States

October Term, 1941.

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**No. 1186**

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MODERN FACTORS COMPANY,

*Petitioner,*

*vs.*

TASTYEAST, INC.,

*Respondent.*

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ON PETITION FOR WRIT OF CERTIORARI.

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## BRIEF IN OPPOSITION TO PETITION.

### Facts.

The petitioners seek a writ of *certiorari* to review a judgment of the Circuit Court of Appeals, Third Circuit, which holds that the provisions of a promissory note and a chattel mortgage securing the same, purporting to obligate the maker to pay interest at  $2\frac{1}{2}\%$  per month after maturity, constituted a penalty and was therefore unenforceable in a bankruptcy court.

On March 25, 1940, the petitioners Louis J. Singer and Jacob Singer, doing business under the trade name of Modern Factors Company, held a promissory note of Tastyeast Inc., on which the principal sum of \$27,000 was due and unpaid. The petitioners then advanced to the

respondent "an additional loan" of \$6,600 and took a renewal note for \$33,600, secured by a chattel mortgage upon respondent's corporate assets. Both the note and mortgage contained the following provisions respecting the payment of principal and interest:

" \* \* \* commencing April 8th, 1940 and each and every two weeks thereafter, consecutively, the sum of \$400.00, without interest, up to September 25th, 1940, at which time the unpaid balance shall become due and payable; *from and after September 25th, 1940 interest on said unpaid balance shall be paid at the rate of 2½% per month*" (Appendix Below, p. 8).

Neither the note nor the mortgage contained any other provision for payment of principal or interest.

On June 25, 1940, the respondent filed a petition for reorganization under Chapter X of the Bankruptcy Act. At that date five payments of \$400 each had been made on account of principal, thus reducing the loan to \$31,600.

From this so-called "additional loan" the petitioners retained the sum of \$3,600, declaring that "the mortgagee, with the consent of the mortgagor is being repaid the sum of \$3,600 in payment of appraisal fees, service and finance charges and other expenses incurred in making this loan" (Appendix Below, p. 9). The fact is that \$3,600 of the "additional loan" was retained by the petitioners and never paid to the respondent. This sum included interest at the rate of 20% per annum (10% for six months) on the total principal of the note and mortgage, plus \$240 for "other expenses" alleged to have been incurred in connection with the renewal of the loan. It was admitted throughout the proceeding below that interest at the rate of 20% per annum on \$33,600 was paid in advance. The interest thus paid in advance was computed on the principal of the note and mortgage and no refund or allowance was made in favor of the respondent. The interest so re-

tained was approximately 21% of the principal actually outstanding.

The respondent was adjudged insolvent, but no adjudication of bankruptcy was made.

On September 25, 1940, the maturity date, default was made in the payment of principal. The assets of the respondent were then in possession of, and being administered by the bankruptcy court in reorganization proceedings.

After the adjudication of insolvency, a Plan of Reorganization was proposed by the debtor, which, after certain amendments and changes, provided for payment to the petitioners of the principal of \$31,600, together with interest thereon after the date of maturity, *at a rate to be determined by the court* on approval of the Reorganization Plan (Appendix Below, p. 10). That Plan also provided among other things, that a new corporation should be organized under the laws of New Jersey, to be called "Tastyeast, Inc.", to which all the property and assets of the debtor corporation should be transferred; that the new corporation should issue preferred and common stock; that all general creditors should receive \$1.00 par value of the preferred stock of the new corporation for each \$4.00 of indebtedness; that "such preferred shares when issued \* \* \* shall constitute payment in full and a discharge of all claims and interest of general creditors against the debtor". (10 (a) Order Confirming Altered Plan, etc., Appendix Below, p. 4).

For the purpose of fixing the rate of interest to be paid subsequent to maturity, the debtor moved before the Referee to fix the rate of interest subsequent to maturity, at a reasonable rate, and not more than 6% per annum. The Referee overruled this motion and in his report recommended that the interest rate be fixed at 2½% per month on the unpaid principal of \$31,600 from the maturity date. September 25, 1940.

Thereafter, the District Court Judge confirmed the Referee's report and ordered the respondent to pay the petitioners the principal of \$31,600, plus interest from September 25, 1940, at the rate of  $2\frac{1}{2}\%$  per month to the date of payment.

In the Order Confirming the Altered Plan, the court granted leave to the respondent to appeal from so much of its determination as awarded petitioner's interest in excess of  $\frac{1}{2}\%$  per month, or 6% per annum (Appendix Below, bottom p. 5), *on condition* that pending the appeal (a) the petitioners be paid the principal sum of \$31,600, plus interest thereon at the rate of 6% per annum from September 25, 1940, to the date of payment (Subsection III (a) Appendix Below, p. 5); (b) that the respondent deposit with the Clerk of the United States District Court for the District of New Jersey a sum equal to 2% per month on the principal sum of \$31,600 from September 25, 1940 to the date of deposit (Appendix Below, p. 6); (c) that the respondent file a cost bond or deposit cash in the amount of \$250 in lieu thereof, with the Clerk of said Court; (d) that the debtor deposit with the Clerk of said Court an additional sum of \$250 in cash to cover interest charges at 6% per annum on the sum of item (b) from the date of deposit to the date of the determination of the appeal.

Pursuant to that order the respondent has deposited cash in the sum of \$5,645.87, being the amount of increased interest in dispute, together with the sum of \$500 to cover the above items (c) and (d). Said amounts still remain on deposit with the Clerk of said Court.

The sole ground on which a writ of *certiorari* is sought is the alleged error of the Circuit Court of Appeals in reversing the order of the District Court insofar as it awarded to the petitioners additional interest at the rate of 2% per month, to be computed on the sum of \$31,600 from September 25, 1940.

## ARGUMENT

### I.

**The provisions of the note and mortgage requiring payment of interest at the rate of  $2\frac{1}{2}\%$  per month, constitutes a penalty and is unenforceable in bankruptcy court.**

In *Story's Equity Jurisprudence*, 14th Ed. Vol. 3, § 1726, in discussing the origin of the doctrine that equity will not enforce a penalty, the author says:

“But whatever may be the origin of the doctrine, it has been for a great length of time established and is now expanded so as to embrace a variety of cases not only where money is to be paid but where other things are to be done and other objects are contracted for. In short, the general principle now adopted is that wherever a penalty is inserted merely to secure the performance or enjoyment of a collateral object, the latter is considered as the principal intent of the instrument, and the penalty is deemed only as accessory, and therefore as intended only to secure the due performance thereof or the damage really incurred by the non-performance. In every such case the true test (generally if not universally) by which to ascertain whether relief can or cannot be had in equity is to consider whether compensation can be made or not. If it cannot be made, then Courts of Equity will not interfere. If it can be made, then if the penalty is to secure the mere payment of money, Courts of Equity will relieve the party upon paying the principal and interest.”

And in § 1732, the author says:

“In the next place in regard to cases of forfeitures. It is a universal rule in equity never to en-

force either a penalty or a forfeiture. Therefore Courts of Equity will never aid in the divesting of an estate for a breach of a covenant on a condition subsequent, although they will often interfere to prevent the divesting of an estate for a breach of a covenant or condition."

In *Van Buren v. Digges*, 11 How. 460, Digges agreed to build for Van Buren a house and have the same completed and ready for occupancy by December 25, 1844. Digges agreed to forfeit 10% of the whole amount if the house should not be entirely completed for occupancy on the date specified in the contract.

Van Buren failed to pay the contract price and Digges brought suit. The defendant set up various defenses, among them that the house was not completed on December 25, and that he was entitled to a deduction of 10% of the entire amount because of this breach of contract. The Court said (p. 476):

"\* \* \* The clause of the contract providing for the forfeiture of ten per centum on the amount of the contract price, upon failure to complete the work by a given day, cannot properly be regarded as an agreement or settlement of liquidated damages. The term 'forfeiture' imports a penalty; it has no necessary or natural connection with the measure or degree of injury which may result from a breach of contract, or from an imperfect performance. It implies an absolute infliction, regardless of the nature and extent of the causes by which it is superinduced. Unless, therefore, it shall have been expressly adopted and declared by the parties to be a measure of injury or compensation, it is never taken as such by courts of justice, who leave it to be enforced where this can be done in its real character, viz: that of a penalty."

In *United Shoe Machinery Co. v. Abbott*, 158 Fed. 762 (C. C. A. 8), the Court recognizes the rule here contended for and said, page 764:

“A contract by a debtor to pay an amount in excess of lawful interest in the event of his default in the payment when due of a simple contract debt is a contract for a penalty, against public policy, and unenforceable”.

In *Re Merwin & Willoughby Co.*, 206 Fed. 116 (U. S. Dis. C. Northern Dis. of N. Y.), the claimant leased to Merwin & Willoughby Co. a store service system for ten years. The lease provided that in case of breach by the lessee, or its bankruptcy, the rent for the entire term of ten years should become immediately due, and that after breach the lessor might re-enter and thereby terminate all rights and interest of the lessee.

About a year after the service was installed, the lessee became bankrupt and it was then in default. The Receiver used the system until he sold the store, and paid rent for that time. The lessor filed a claim for rent for the entire remainder of the term. The Court held that the terms of the lease constituted a penalty and that the claim was unconscionable, and would not be allowed against the bankrupt estate, citing *United States Shoe Machinery Co. v. Abbott*, 158 Fed. 762.

In discussing Penalties & Forfeitures in Williston on Contracts, Revised Edition, Volume 3, Sec. 784, the author says:

“It will be held to be a penalty if the sum stipulated for is extravagant and unconscionable in amount in comparison with the greatest loss that could conceivably be proved to have followed from the breach.”

*Citing, Clydebank Engineering etc. Co. vs. Castaneda, A. C. 6.*

In Vol. 21 *Corpus Juris* 99, Sec. 71 Equity—Penalties and Forfeitures—under the caption Increased Rate of Interest, it is said:

“A familiar application of this doctrine, where the contract is one for the payment of money, is where it is provided that a higher rate of interest shall be paid unless the debt is paid upon its maturity. This provision is treated as a penalty and equity forbids the enforcement of the higher rate.”

Usury and Penalty are distinct defenses to the enforceability of a contract. Because an agreement is not usurious, it does not necessarily follow that it may not involve a penalty. This distinction is illustrated in *In re Liberty Doll Co. Inc.*, 242 Fed. 695, where the Court construed a provision in a contract which purported to give rise to a claim of \$2500 for commissions due the claimant for services rendered to the bankrupt under a contract. It was held, that while the contract was not usurious, because the bankrupt, being a corporation, could not plead usury, under the State law, it was nevertheless unconscionable, and the provision complained of was in the nature of a penalty. In disposing of this feature of the case, the Court said:

“Undoubtedly, as between private individuals, the provision of the ninth paragraph would be void for usury, because the obligation to pay, irrespective of service rendered, clearly would make the \$2,500 a bonus for a loan. As against this bankrupt corporation, the provision is certainly in the nature of a penalty. Two rules are well established: (1) That where the sum agreed upon is so great as to be unconscionable, it will be regarded as a penalty; (2) that where the stipulated amount is disproportionate to presumable and possible damages, or to a readily

ascertainable loss, the courts will treat it as a penalty."

In determining the validity of a claim in Bankruptcy the Court construed a provision in a contract in the case *In re Gelino's, Inc.*, reported in 43 F. (2nd) 832 (certiorari denied 284 U. S. 659; 76 L. Ed. 558) and decided that it amounted to a claim for a penalty and limited the recovery to the actual damages sustained. In following the rule stated in *In re Liberty Doll Co., supra*, the Court said:

"Where the sum named in a contract to be paid on a breach is wholly disproportionate to the actual damages sustained, the Court will deem the parties to have intended to stipulate for a mere penalty to secure performance, and not for a liquidation of damages".

In holding that the provisions of the note and mortgage involved in the present case constituted a penalty, the Circuit Court of Appeals followed the well established rule enunciated by the foregoing authorities. Judge CLARK is clearly justified in stating:

"We fail to find any direct relation between the increased rate and the anticipated loss which a default might have caused the mortgagee. Rather it seems to us that the mortgagee definitely intended to enforce a penalty upon the debtor. The inequality in their bargaining positions is evident since the mortgagee was able to extract a prepaid interest of approximately 21%. The debtor's overpowering economic need induced it to undertake the risk of the huge increase in interest and the possibility that it would be liable for 30% interest upon its unpaid 21% interest. As we view the transaction, both parties knew the increase was intended only to coerce the debtor into a prompt payment upon maturity. As such it was an agreement for a penalty and unenforceable in bankruptcy."

## II.

**The cases cited by petitioners are not applicable to the question of penalty.**

Counsel for the petitioners cites numerous cases which deal with the question of usury and liquidated damages. We do not find among them any authorities applicable to contracts which provide for the enforcement of a penalty. They are therefore not in point.

The case of *Ramsay v. Morrison*, 39 N. J. L. 591, is cited as supporting petitioners' contention that the contract in question is not illegal.

The legality of that contract was attacked because it was claimed to be usurious. On that point the Court said (p. 593):

"The contract is not usurious. This being the only point raised, the plaintiff is entitled to judgment upon the report, and the rule is discharged."

## III.

**The decision of the Circuit Court of Appeals does not impair any right of petitioners under the federal constitution, or otherwise.**

The petitioners complain that their contract rights have been impaired. They build up that claim on the contention that the contract is not usurious. The respondent is not attacking the contract as usurious, but as one imposing a penalty. That being the case, the contract does not impose a legal obligation upon respondent to pay 30% interest. Hence, under it the petitioners are entitled only to the dam-

ages which they have sustained, but the damages suffered by the petitioners for failure to pay money on the due date, is the lawful rate of interest. This has already been paid to the petitioners, and they have thereby received full compensation for respondent's failure to pay on the due date.

In *United States Shoe Machinery Co. v. Abbott*, 158 Fed. 762, the Court said, at page 763:

"Legal interest is the measure of damages for the failure to pay debts when they are due, and hence a contract to pay an amount in excess of such interest on account of a default in the payment of money when it is due is an agreement for a penalty which the courts will not enforce."

There was no error in the decision of the Circuit Court of Appeals and the application for a writ of certiorari should be denied.

Respectfully submitted,

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